

Office of Inspector General
Washington, DC 20546-0001



JAN 28 2004

TO: A/Administrator
B/Chief Financial Officer

FROM: W/Inspector General

SUBJECT: Audit of the National Aeronautics and Space Administration's
Fiscal Year 2003 Financial Statements

Under the Chief Financial Officers (CFO) Act of 1990, NASA's financial statements are to be audited in accordance with generally accepted government auditing standards. The Office of Inspector General (OIG) selected the independent certified public accounting firm PricewaterhouseCoopers LLP (PwC) to audit NASA's financial statements in accordance with Government Auditing Standards and Office of Management and Budget (OMB) Bulletin 01-02, "Audit Requirements for Federal Financial Statements." The Defense Contract Audit Agency (DCAA) performed supporting work related to contractor-held, NASA-owned material and property, plant, and equipment.

In the enclosed *Report of Independent Auditors*, dated January 20, 2004, PwC disclaimed an opinion on NASA's financial statements for the fiscal year ended September 30, 2003. The disclaimer resulted from NASA's inability to provide PwC with sufficient evidence to support the financial statements and complete their audit within timeframes OMB established.

PwC's *Report of Independent Auditors on Internal Control* includes five reportable conditions of which four are considered to be material weaknesses. Material weaknesses were found in NASA's: (1) ability to provide documentation and an audit trail to support the financial statements, (2) controls reconciling Fund Balance with Treasury, (3) financial statement preparation, and (4) controls over property, plant, and equipment. Less significant weaknesses were found in security controls over NASA's financial management systems. As a result of the material weaknesses identified in internal controls, PwC's *Report of Independent Auditors on Compliance with Laws and Regulations* states that NASA's financial management system is not in compliance with the requirements of the Federal Financial Management Improvement Act (FFMIA).

To address the weaknesses in NASA's financial management system, we recommend that NASA establish senior management teams to:

- Ensure there is an appropriately staffed organizational structure that can address the Agency's financial management and accountability challenges.
- Review current accounting policies and procedures to ensure they are consistent with applicable standards and are consistently applied.

- Establish internal controls that will provide reasonable assurance that the financial statements are supported, complete and accurate.
- Address problems with the implementation of the Integrated Financial Management Program, including those identified by the General Accounting Office in its November 2003 reports.
- Implement the recommendations made in PwC's *Report of Independent Auditors on Internal Control*.

PwC is responsible for each of the enclosed reports and the conclusions expressed within. Accordingly, we do not express an opinion on NASA's financial statements, conclusions about internal controls over financial reporting, or compliance with certain laws and regulations including, but not limited to, FFMIA.

In fulfilling our responsibilities under the CFO Act, we provided oversight and technical support. We monitored the progress of the audit, coordinated the work performed by the DCAA, reviewed reports submitted by PwC and the DCAA, and ensured that PwC met their contractual requirements.



Robert W. Cobb

3 Enclosures

Report of Independent Auditors

To Office of Inspector General of the
National Aeronautics and Space Administration:

We were engaged to audit the accompanying Consolidated Balance Sheet of the National Aeronautics and Space Administration (NASA) as of September 30, 2003, and the related Consolidated Statements of Net Cost, of Changes in Net Position, and of Financing and the Combined Statement of Budgetary Resources for the year then ended. These financial statements are the responsibility of NASA's management.

As discussed in the following paragraph, NASA did not provide sufficient documentary evidence in support of its financial statements as of and for the year ended September 30, 2003, thereby limiting the scope of our work such that we are not able to express, and we do not express, an opinion on these financial statements.

During fiscal year 2003, NASA implemented an Integrated Financial Management Program (IFMP) system, specifically the Core Financial Module. NASA management identified significant errors in its June 30, 2003, financial statements resulting from the implementation of the IFMP system. NASA management communicated that it would correct these errors in the September 30, 2003, financial statements. When NASA first prepared its September 30, 2003, financial statements, NASA concluded that these financial statements also contained significant errors. NASA's efforts to correct these errors led to significant delays in its completion of the September 30, 2003, financial statements and its compilation of documentation in support of amounts and disclosures in these financial statements, including support for resolution of the June 30, 2003, financial statement errors. The documentation NASA provided in support of its September 30, 2003, financial statements was not adequate to support \$565 billion in adjustments to various financial statement accounts, which it identified as being related to the conversion of data to the IFMP system; \$2 billion in net adjustments to its Fund Balance with Treasury account, which had the effect of reducing NASA's recorded balance so it equaled Treasury's reported balance; and its corrections of the financial data errors that affected its June 30, 2003, and September 30, 2003, financial statements. Because of the delays in preparation of the September 30, 2003, financial statements, it was not possible to pursue further evidence in support of these transactions and amounts, nor was it possible to complete other planned auditing procedures within the reporting deadline established by Office of Management and Budget (OMB). Thus, we could not complete our audit and were unable to determine whether there were other matters that are required to be reported.

The following three paragraphs describe departures from accounting principles generally accepted in the United States of America in NASA's fiscal year 2003 financial statements.

NASA did not disclose in the notes to its financial statements that at September 30, 2003, there was a significant difference between its Fund Balance with Treasury balance per its general ledger and Treasury's reported balance, as required by OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*.

NASA's method of presentation of its Statement of Financing for the year ended September 30, 2003 was not consistent with the method of presentation of its Statement of Financing for the year ended September 30, 2002.

In fiscal year 2003, NASA allocated depreciation expenses and capitalized costs on a prorated basis utilizing labor hours charged to NASA's programmatic budget line items. In fiscal year 2002, NASA allocated depreciation expenses and capitalized costs to NASA's programs based on the percentage of current year costs per Center. NASA did not provide justification that this change in accounting method is preferable nor did NASA adequately disclose this change in the notes to its financial statements, as required by Statement of Federal Financial Accounting Standards No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*.

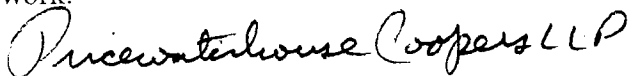
The Management's Discussion and Analysis, Required Supplementary Information, and Required Supplementary Stewardship Information are not required parts of the basic financial statements but are supplementary information required by the Federal Accounting Standards Advisory Board and OMB Bulletin No. 01-09. This information has not been subjected to auditing procedures; accordingly, we express no opinion on this information. Further, we were unable to apply to the information certain procedures prescribed by professional standards within the reporting timelines established by OMB, because of the limitations on the scope of our audit of the financial statements, as discussed in the third paragraph of this report.

We have audited the accompanying Consolidated Balance Sheet as of September 30, 2002, and the related Consolidated Statements of Net Cost, of Changes in Net Position, and of Financing and the Combined Statement of Budgetary Resources for the year then ended. These financial statements are the responsibility of NASA's management; our responsibility is to express an opinion on these financial statements based upon our audit. We conducted our audit of these statements in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial

Report of Independent Auditors
Page 3 of 3

statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion. In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of NASA at September 30, 2002, and its net cost, changes in net position, budgetary resources, and financing for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated January 20, 2004, on our consideration of NASA's internal control over financial reporting and a report dated January 20, 2004, on its compliance with laws and regulations. These reports, which disclose material weaknesses and a reportable condition in internal control and non-compliance with the Federal Financial Management Improvement Act, are an integral part of an audit conducted in accordance with *Government Auditing Standards*, and should be read in conjunction with this report on the financial statements when considering the results of our work.



Washington, D.C.
January 20, 2004

Report of Independent Auditors on Internal Control

To Office of Inspector General of the
National Aeronautics and Space Administration:

We were engaged to audit the financial statements of the National Aeronautics and Space Administration (NASA) as of and for the year ended September 30, 2003, and have issued our report thereon dated January 20, 2004, in which we disclaimed an opinion on those financial statements.

In planning and performing our work, we considered NASA's internal control over financial reporting by obtaining an understanding of NASA's internal control, determined whether internal controls had been placed in operation, assessed control risk, and performed tests of controls. We limited our internal control testing to those controls necessary to achieve the objectives described in Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act (FMFIA) of 1982, such as those controls relevant to ensuring efficient operations. The objective of our work was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants (AICPA), reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment, could adversely affect the agency's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal controls, misstatements, losses, or noncompliance may nevertheless occur and not be detected. However, we noted certain matters discussed in the following paragraphs involving the internal control and its operation that we consider to be material weaknesses and a reportable condition under standards established by the AICPA and OMB Bulletin No. 01-02.

Material Weaknesses:

NASA Lacks a Sufficient Audit Trail to Support that Its Fiscal Year 2003 Financial Statements Are Presented Fairly

During our testing, we found that NASA did not maintain or have readily available sufficient documentation to support its financial statements. OMB Circular No. A-123, *Management Accountability and Control*, and the General Accounting Office's (GAO), *Standards for Internal Control in the Federal Government*, require agencies to maintain documentation for transactions, management controls, and other significant events that is clear and readily available for examination. In fiscal year 2003, NASA implemented an Integrated Financial Management Program (IFMP) system, specifically the Core Financial Module. We noted that the complexity of NASA's conversion approach and the pervasiveness of the errors identified during the compilation of its June 30, 2003, and September 30, 2003, financial statements and the resolution of those errors impeded NASA's ability to provide a sufficient audit trail to demonstrate the accuracy and completeness of its September 30, 2003, financial statements.

NASA management identified numerous errors in its June 30, 2003, financial statements resulting from the implementation of the IFMP system:

- NASA's Fund Balance with Treasury balance did not reconcile to the general ledger, and the balance was materially overstated due to data conversion errors.
- The IFMP system did not require data fields to be populated to properly distinguish transactions as Intragovernmental or With the Public on the Consolidated Balance Sheet and Consolidated Statement of Net Cost and to allocate costs on the Consolidated Statement of Net Cost. Those data fields were not populated for all transactions, resulting in errors in classifying transactions as Intragovernmental or With the Public and in allocating costs on the Consolidated Statement of Net Cost.
- The Other line item of \$204 million on the Consolidated Statement of Financing under the Components Not Requiring or Generating Resources could not be explained or supported, indicating that NASA had not correctly reconciled its budgetary resources to its net cost of operations.
- There were inconsistencies with financial statement line items. For example, the Obligations Incurred balance on the Combined Statement of Budgetary Resources did not agree to the Obligations Incurred balance on the Consolidated Statement of Financing, a difference of approximately \$200 million.

The pervasiveness of these errors prevented us from performing significant substantive audit procedures on NASA's June 30, 2003, financial statements.

NASA management communicated that these and other errors identified by NASA management would be corrected in the September 30, 2003, financial statements. When NASA first prepared its September 30, 2003, financial statements, it concluded that there were still significant problems with the accuracy of its financial statements. NASA's efforts to correct these problems led to significant delays in its completion of these financial statements and its compilation of documentation in support of amounts and disclosures in these financial statements, including support for resolution of the June 30, 2003, financial statement errors.

In preparing its September 30, 2003, financial statements, NASA posted 89 adjustments, outside of its IFMP system. NASA provided 87 of the 89 adjustments, totaling approximately \$582 billion. Per review of the description of the adjustments provided, 39 of these adjustments, totaling nearly \$565 billion, were identified as related to data conversion. NASA's conversion approach included loading into its new financial system transactions from the 7 prior fiscal years as if they were current year activity, thereby overstating NASA's converted balances. As support for the correction of these and other data conversion errors, NASA provided each Center's conversion Center Action Plan. In examining these Center Action Plans, we noted that the original differences between the legacy system balances and the IFMP system beginning balances at conversion totaled approximately \$16 billion, net, and that the amount of differences corrected throughout the fiscal year was approximately \$393 million, net. Additionally, we noted that there were differences not requiring adjustment, totaling approximately \$5 billion, net, as well as remaining differences that needed to be corrected, totaling approximately \$11 billion, net. We noted five adjustments, totaling \$1.5 billion that specifically related to the remaining differences that the Center Action Plans had indicated needed to be corrected at September 30, 2003. However, NASA did not provide sufficient documentary evidence to explain how it addressed the full \$11 billion that the Center Action Plans indicated required correction at September 30, 2003, nor did it provide sufficient documentary evidence to support the purpose and validity of the other \$563.5 billion in adjustments it identified as being related to data conversion.

The transaction populations provided for our statistical sample testing of fiscal year 2003 cost, obligation and disbursement transactions contained significant anomalies. For example, NASA identified significant errors that were caused by a limitation in its IFMP system, whereby the IFMP system did not include all of the necessary accounting detail associated with a transaction when processing the total transaction amount. Additionally, the populations provided included corrections to prior year data. As mentioned above, NASA's conversion approach included converting 7 years of prior year data, which was processed as if it were current year activity. NASA could not readily identify these correction transactions in the populations provided. In both of these examples, NASA did not provide a comprehensive listing of the transactions affected by these anomalies, which resulted in significant delays in finalizing our sample design and alternative testing approach, since we could not adequately define the composition of the transaction populations provided. Furthermore, NASA did not provide sufficient documentation to

support the identification, resolution and correction of these anomalies, in accordance with GAO and OMB internal control standards. This material weakness was not reported in NASA's Federal Managers' Financial Integrity Act (FMFIA) report.

We recommend that NASA Management:

- Establish or revise policies and procedures addressing documentation of non-routine transaction processing, and post-closing adjustments that are consistent with GAO's internal control standards. The policies should enable NASA to provide sufficient evidence to support its financial statements. These policies and procedures should address:
 - Non-routine transactions: During fiscal year 2003, NASA found it necessary to process a significant volume of non-routine transactions in its financial statements. For example, it posted entries to correct differences between the opening balances in its new financial system and the closing balances in its legacy systems. It also reversed and re-posted a number of transactions that led to errors in the June 30, 2003, financial statements. Documentation of such non-routine transactions should include an overview of the event necessitating the non-routine transactions, including the cause of the event, and a description of the processes NASA followed to ensure itself that it has (1) identified all transactions that had been posted to the system in error, (2) reversed only those transactions that were in error, (3) posted accurate corrections of the transactions it reversed, and (4) did not post any transactions other than the authorized corrections. That documentation should be sufficient so that an auditor could reperform NASA's steps and determine if they were executed correctly.
 - Post-closing adjustments: A sufficient audit trail for all adjustments posted outside of its IFMP system needs to be maintained. At a minimum, the audit trail should consist of documentation for each adjustment that includes (1) U.S. Standard General Ledger (SGL) accounts, the debit(s) and credit(s), and the dollar amounts, (2) detailed description of the specific purpose of the adjustment, and (3) source documentation that supports the amount of the adjustment. The supporting documentation should be organized such that it is clear and readily available for examination.
- Apply the documentation standards recommended above to all previously identified significant events, including the errors identified during the implementation of its IFMP system, as well as the compilation of its June 30, 2003, and September 30, 2003, financial statements. Additionally, this

documentation standard should be applied to future significant events to ensure that sufficient documentary evidence exists in support of NASA's transactions, management controls and significant events.

- Prepare an analysis of all adjustments posted outside of its IFMP system, by SGL account and financial statement line item. This will enable NASA to demonstrate an understanding of the magnitude of adjustments associated with each SGL account and financial statement line item as well as assist in the analysis of its financial statements to ensure that logical relationships exist between various financial statement amounts, and that the relationships between the different statements and line items within each statement are appropriate.
- Ensure that the adjustments posted outside of its IFMP system to generate its September 30, 2003, financial statements, are subsequently posted into the IFMP system. This will ensure that NASA's IFMP general ledger is complete, its September 30, 2003, financial statements agree to the system of record, and the beginning balances are accurate for fiscal year 2004.

NASA Lacks Effective Internal Controls Surrounding Its Fund Balance with Treasury Reconciliations

A fundamental accounting control is the reconciliation of the general ledger, from which financial statements are prepared, to subsidiary systems and/or records. Reconciliations are necessary to ensure that transactions are completely and accurately recorded and that the reported balances are correct. A critical reconciliation for all Federal agencies is the reconciliation of the agencies' Fund Balance with Treasury balance to the U.S. Department of the Treasury's accounting records. In its report titled, *Financial Audit, Issues Regarding Reconciliations of Fund Balances with Treasury Accounts*, GAO noted that the reconciliation process that agencies perform between their Fund Balances and Treasury accounts is an important tool in ensuring that the federal government is able to accurately measure the full cost of its programs. The lack of effective reconciliations increases the risk of fraud, waste, and mismanagement.

According to NASA's policies and procedures, each Center is required to perform monthly reconciliations of its Fund Balance with Treasury activity per the general ledger to Treasury's reported balance. At two of the five Centers we visited during our interim fieldwork, we noted that supporting documentation from the general ledger could not be provided to substantiate the general ledger amounts captured on each Center's reconciliation between its Fund Balance with Treasury balance to Treasury's reported balance.

NASA communicated that Headquarters also prepares monthly reconciliations of each Center's Fund Balance with Treasury activity per the general ledger to Treasury's

reported balance. We identified significant inconsistencies with the supporting documentation provided for NASA's September 30, 2003, Fund Balance with Treasury balance. For example, we reviewed Headquarters' Fund Balance with Treasury reconciliations as of September 30, 2003, and noted an agency-wide difference of approximately \$43 million, net, between NASA's general ledger and the U.S. Department of the Treasury's reported balance. NASA did not provide sufficient documentary evidence to explain these unreconciled differences. In GAO's report titled, *Financial Audit, Issues Regarding Reconciliations of Fund Balances with Treasury Accounts*, GAO noted that in order to effectively reconcile Fund Balance with Treasury accounts, agencies must timely research and resolve any differences between their records and what Treasury has reported. Additionally, NASA provided approximately 20 adjustments, posted outside of its IFMP system, which indicated that the difference between its Fund Balance with Treasury balance and Treasury's balance was significantly greater than had been presented in its year-end reconciliation. As a result, NASA recorded adjustments of \$2 billion, net, to decrease its Fund Balance with Treasury balance to agree to the U.S. Department of the Treasury's reported balance at September 30, 2003. We determined that 5 out of the 20 adjustments, totaling approximately \$1 billion, related to data conversion errors per the Center Action Plans. The remaining adjustments, which were also identified as related to data conversion, totaled approximately \$3 billion. NASA did not provide sufficient documentary evidence to explain the linkage between these adjustments and the unreconciled differences identified on Headquarters' Fund Balance with Treasury reconciliations as of September 30, 2003. This material weakness was not reported in NASA's FMFIA report.

We recommend that NASA Management:

- Ensure that all reconciling items identified on its Fund Balance with Treasury reconciliations are thoroughly researched, contain documented explanations and resolution actions, and are maintained for a sufficient audit trail.
- Retain all reports and documentation utilized in compiling its Fund Balance with Treasury reconciliations, including all support used in researching and resolving reconciling differences.
- Ensure that its Headquarters policies and procedures for performing its consolidated Fund Balance with Treasury reconciliation are documented and reflect the recommendations stated above.

NASA's Processes for Preparing Its Financial Statements Still Require Improvement

In our fiscal year 2002 Report on Internal Controls dated January 24, 2003, we recommended that NASA improve its overall financial reporting process to reasonably assure that information presented on the financial statements and footnote disclosures, are

accurate and are consistent with the requirements of OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. As a result of these recommendations, NASA demonstrated some progress in implementing our recommendations, such as, conducting technical training for its staff and devising an internal quality review checklist. However, some significant weaknesses remain.

Originally, NASA was to provide us with its final September 30, 2003, financial statements on October 31, 2003. However, we received these financial statements on December 10, 2003. NASA management communicated that this delay resulted from data quality issues related to their data conversion effort.

Upon review of the statements, we noted inconsistencies that should have been identified and corrected by NASA management through its internal quality control review. For example, NASA did not disclose in its fiscal year 2003 Fund Balance with Treasury footnote that there was a significant difference between its general ledger and Treasury's reported balance, as required by OMB Bulletin No. 01-09. NASA's method of presentation of its Statement of Financing for the year ended September 30, 2003 was not consistent with the method of presentation of its Statement of Financing for the year ended September 30, 2002. Additionally, in fiscal year 2003, NASA allocated depreciation expenses and capitalized costs on a prorated basis utilizing labor hours charged to NASA's programmatic budget line items. In fiscal year 2002, NASA allocated depreciation expenses and capitalized costs to NASA's programs based on the percentage of current year costs per Center. NASA did not provide justification that this change in accounting method is preferable, nor did NASA adequately disclose this change in the notes to its financial statements, as required by Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*.

Furthermore, during our interim testing we identified situations where costs are not recorded properly. NASA designed its new Core Financial Module to include a system edit whereby if costs (and the corresponding liabilities) are greater than the associated obligations, the difference would not be recorded in NASA's general ledger. Instead, these differences were transferred outside of its general ledger and held in a suspense file until additional funds were obligated and the excess costs (and the corresponding liabilities) could be recorded. Similarly, the Core Financial Module did not allow negative costs or downward adjustments to be recorded in the general ledger. SFFAS No. 1, *Accounting for Selected Assets and Liabilities*, SFFAS No. 4, and NASA's Financial Management Manual require costs to be accrued in the period in which they are incurred and any corresponding liability to be recorded as an account payable, regardless of the associated amounts obligated.

Due to the magnitude and pervasiveness of errors NASA identified during the implementation of its IFMP system and during the compilation of its June 30, 2003, and September 30, 2003, financial statements, the delays in preparation of the September 30,

2003, financial statements, and the lack of sufficient audit trail to support that NASA's financial statements are presented fairly, it was not possible to complete further audit procedures on NASA's September 30, 2003, financial statements within the reporting deadline established by OMB. As a result, we were unable to determine if NASA effectively implemented all of the recommendations outlined in our fiscal year 2002 Report on Internal Controls dated January 24, 2003. This material weakness was not reported in NASA's FMFIA report.

We recommend that NASA Management:

- Continue to improve its financial reporting internal quality review procedures to reasonably assure that information presented on the financial statements, footnote disclosures, Management's Discussion and Analysis (MD&A), Required Supplementary Information, and Required Supplementary Stewardship Information (RSSI) are accurate and are consistent with the requirements of OMB Bulletin No. 01-09. To ensure the accuracy and completeness of work performed, supervisory reviews should be guided by preparation of a comprehensive checklist, such as that included in the GAO/PCIE's *Financial Audit Manual*.
- Complete and document analytical procedures to ensure that logical relationships exist between various financial statement amounts, and that the relationships between the different statements and line items within each statement are appropriate. Variances from expected results should be researched and resolved.
- Devise a NASA-wide detailed timeline with specific milestones to ensure ample time and resources are available to complete the following tasks associated with preparing the financial statements and other elements of the performance and accountability report (1) data collection, (2) data validation, (3) data compilation, and (4) detailed quality review.
- Devise a systematic methodology for ensuring that its accounting policies and procedures are in compliance with generally accepted accounting principles. These policies and procedures should be established at NASA Headquarters and disseminated to the Centers on a timely basis. Additionally, NASA should establish appropriate monitoring controls at the Headquarter level to ensure that all Centers are applying its policies and procedures consistently and uniformly.
- Ensure that systems used to prepare the financial statements are complete and have been sufficiently tested prior to interim and year-end reporting dates.
- Devise short-term and long-term resolutions to these IFMP systematic issues and the lack of internal controls surrounding costs in excess of obligations and downward adjustments.

NASA Still Lacks Adequate Controls to Reasonably Assure that Property, Plant and Equipment and Materials Are Presented Fairly in the Financial Statements

During fiscal year 2002, we reported Property, Plant and Equipment (PPE) and Materials together as a material weakness due primarily to the lack of internal controls surrounding Contractor-Held PPE and Materials and NASA-Held Assets in Space and NASA-Held work in progress (WIP). In addition, we reported a lack of adequate oversight by NASA Headquarters to identify deficiencies in the design and operation of internal controls for both components.

During fiscal year 2003, NASA management created an overall Corrective Action Plan (Plan) to remedy deficiencies communicated within last year's report. Deadlines were established and accountability assigned within NASA and its contractors to implement all recommendations in fiscal year 2003.

As a result of this Plan, NASA management demonstrated some progress during the year. However, our fiscal year 2003 testing identified that deficiencies still exist, including significant errors discovered through our substantive testing and unresolved prior year recommended corrective actions at certain individual contractor locations. As a result, we were unable to rely on Contractor-Held PPE and Materials reporting and were required to seek audit satisfaction by extensive substantive testing. Additionally, management is unable to detect and correct significant errors before issuing their financial statements. Both interim and year-end financial statements contained significant accounting and reporting errors.

As such, NASA still lacks adequate internal controls to reasonably assure that PPE and Materials are presented fairly in its financial statements. As a result of the testing that was completed in fiscal year 2003, the following is the status of the recommendations from last year:

- The following prior-year recommendations are considered unresolved:
 - We recommended that NASA require contractors to create plans to resolve their respective deficiencies and NASA establish internal controls and policies and procedures to ensure these are created and carried out. During fiscal year 2003, NASA sent correspondence requesting that this be implemented. However, based upon fiscal year 2003 testing, contractors continue to report significant inaccurate and incomplete PPE and materials data. As such, we consider this recommendation still unresolved.
 - We recommended that NASA ensure that all of its contractors have formal policies and procedures to detect and correct errors reported on the NASA Form (NF) 1018. Errors identified in our fiscal year 2003 testing demonstrated that this recommendation is still unresolved. We also

recommended that NASA require its contractors to review PPE and Materials reported by subcontractors on NF 1018 before submitting to NASA. Although NASA's FAR Supplement now requires these formal policies and procedures, additional errors identified in our fiscal year 2003 testing demonstrate that the internal controls need significant improvement. Specifically, we recommend that NASA management verify that each of its contractors has established and is implementing formal policies and procedures to (1) detect and correct errors reported on the NF 1018 as well as (2) review and verify PPE and Materials reported by subcontractors on the NF 1018 before submitting to NASA. NASA should establish internal controls that corroborate that these policies and procedures are in place and are effective in reducing NF 1018 Contractor reporting risk.

- The remaining recommendations have all been partially implemented and should be completed as soon as possible. This will assist management in meeting accelerated reporting deadlines in the future. For example, the following more significant recommendations should be prioritized:
 - We recommend that NASA transition its fiscal year 2003 Corrective Action Plan into an annual "Audit Plan" that establishes annual objectives pertinent to the Agency's specific PPE and Materials internal control and financial statement reporting goals. The annual objectives should be developed from the results of reviews, inspections, and audits conducted by NASA management, NASA Office of Inspector General, external auditors, and contractors and can include goals such as :
 - Following up on previously reported deficiencies and recommendations, including those issued by DCAA.
 - Reviewing/validating/testing high-risk contractors (e.g., those with prior significant findings and internal control deficiencies or those with significant reported balances) on a thorough and consistent basis to reduce overall NF 1018 reporting risk. Such procedures should include at a minimum an assessment of internal controls and policies and procedures, and if necessary, testing the validation of the contractor's reporting of PPE & Materials (e.g., existence, validity, completeness, accuracy and valuation). In addition, NASA management should consider the inclusion of incentives and penalties for compliance and noncompliance of the NASA FAR Supplement.
 - Continual enhancement of NASA Headquarters Policies and Procedures, NF 1018 Quarterly and Annual Reporting and

Instructions and the NASA FAR Supplement to address risks identified and to ensure that all contractor requirements contained therein meet NASA's needs for financial statement reporting purposes.

- Continuously update checklists for reporting and reviewing PPE and Materials.
- Maintaining regular communications with its contractors (e.g., monthly conference calls, quarterly visits, and internal periodic newsletter/communications).

As internal controls improve, NASA should then consider establishing an annual rotation schedule to review/validate contractors at regular intervals as a proactive and preventive measure.

- As originally recommended last year, NASA attempted to create a team to address and resolve the prior year findings and recommendations. The team, however, lacked sustained senior management involvement. Given the significance of PPE and Materials to NASA financial reporting, we recommend that NASA management establish a team led by a senior member of management and charge that team with resolution of these recommendations surrounding this material weakness.
- During fiscal year 2003, NASA management provided training to its Property Administrators and contractors as recommended. Going forward, we recommend that NASA continue to conduct comprehensive staff training and consider expanding it to focus on specific areas of complexity and risk (e.g., transfer document support and preparation).
- During fiscal year 2003, NASA management modified its NF 1018 reporting for its top 55 contractors from an annual to a quarterly basis. We recommend that NASA further modify the NF 1018 reporting process for the remaining contractors to report on a quarterly basis. This will further facilitate reliable, accurate, and complete quarterly reporting.
- As originally recommended last year, NASA continued to work towards enhancing its requirements to document assets transferred to/from NASA Centers and/or other contractors, including the related transfer forms (e.g., DD 1149, DD 250). Going forward, we recommend that NASA continue to ensure compliance with its documentation requirements by monitoring its contractors through management reviews and inspection visits. Additionally, NASA should continue to require complete supporting

documentation for all PPE and Materials transactions, specifically for asset transfers. Complete supporting documentation includes dates, appropriate dollar amounts, authorizing signatures and invoices or purchase orders behind the transfer document that corroborates the dollar amount. Lastly, we recommend that NASA create a reconciliation process to reconcile all of its asset transfers on a quarterly basis and include within that process formal confirmations between the issuing contractor and the receiving contractor. All of these objectives can be included in the “Annual Audit Plan” described above.

- During fiscal year 2002, we recommended that NASA create formal policies and procedures to ensure all appropriate costs are capitalized as part of NASA-Held Assets in Space and NASA-Held WIP accounts. In addition, we recommended the development of formal cost allocation policies for Assets-in-Space, including specificity of what costs are required to be capitalized and what costs should be expensed. Based upon our fiscal year 2003 testing, we recommend that NASA management enhance its Assets-in-Space policy to specifically include what costs should be capitalized/expensed, including a uniform list of cost identifiers (e.g., Unique Project Numbers [UPNs]) that support each of those assets to ensure its policy is consistently applied and that a sufficient audit trail exists documenting management’s assertions surrounding the value of each asset.

Reportable Condition:

Security Controls in NASA’s Financial Management Systems Environment Need Improvement

Our testing of the IFMP computing environment responsible for processing NASA’s significant financial applications identified improvements needed to strengthen the design and implementation of NASA’s information security program. The suggested improvements can be grouped into the following four categories:

1. IFMP Security Design and Implementation Needs Improvement

The Core Financial Security Plan (MSFC Information Technology (IT) Security Plan) does not conform to OMB Circular No. A-130, *Management of Federal Information Resources*, which, in turn, references the National Institute of Standards and Technology (NIST) publications on computer security. As a result of these gaps in the Core Financial Security Plan, NASA management has not:

- Documented the security configuration standards used to enforce specific security parameters and settings for the IT architecture supporting the IFMP environment.

- Performed an independent “Certification & Accreditation” (C&A) of both the general support systems and the major business application.

In addition, we noted that NASA’s Procedures and Guidelines (NPG) 2810.1 does not clearly articulate the following:

- Policies and procedures requiring that NASA Centers and departments document the security configurations for all general support systems and major applications.
- Specific procedures on how to conduct a C&A, as well as the frequency of these reviews for all general support systems and major applications.

2. IFMP Security Controls Need to be Strengthened

The existing IFMP technical administration procedures and application-level security design need to be improved to provide stronger security over the IFMP application environment. Specific areas of weaknesses noted were:

- System parameters have not been configured to provide the highest level of control.
- High-risk, vendor-supplied profiles were assigned to certain user IDs that have the rights to process system and database updates across all functional and technical areas.
- A significant number of users (technical and end-users) had access to perform activities, such as table maintenance, program processing, database copies, spool management, and batch processing via system-level transactions. The use of system-level transactions for these activities allows a user to bypass manual and system controls that are built into the underlying business processes.
- A significant number of end-users have access to sensitive transactions. In addition, we noted segregation of duty conflicts within the finance and purchasing functions. The existing NASA segregation of duty procedures can only identify user conflicts at the role level, which does not provide adequate visibility of users with access to specific transactions or potential segregation of duty conflicts within a single role.
- Procedures have not been fully or consistently implemented to ensure that visibility and control over user access is properly monitored and addressed. For example, procedures have not been fully implemented for monitoring unused IDs, locked IDs, access re-certifications, and segregation of duty conflicts.

3. General IT Controls Around IFMP Need To Be Strengthened

We identified a number of security software parameters that were either incorrectly set or were not operating effectively in the distributed client server architecture. A few examples of the control weaknesses noted were:

- Some programmers were provided access to the application production environment with create and change privileges.
- Inappropriate access to the operating system files was found on a few servers.
- Certain user accounts were not required to authenticate to the IFMP database, allowing a user with access to the operating system to login to the database with no further authentication.

4. Oversight Function Supporting IFMP's Security Program Needs Improvement

Our review of the IFMP security program revealed that the roles, responsibilities, and oversight function of the new IFMP computing environment needs to be clarified and strengthened to enforce the consistent application of the agency-wide IT Security Program. Specifically, we noted the following:

- Review of NASA Policies and Guidelines document, NPG-2810, and discussions with IFMP management personnel revealed a "center-centric" approach to IT security that NASA has attempted to apply to the new integrated IFMP financial management system. Under the "center-centric" approach, each of NASA's Centers is responsible for developing and maintaining appropriate security guidelines that are relevant to their operation. However, such a decentralized approach, when applied to the IFMP processing environment, creates a potential for conflicts between the different security policies and procedures implemented by the NASA Chief Information Officer's (CIO) office, NASA Centers, and IFMP.
- There appeared to be no mechanism in place to ensure that periodic security controls testing and evaluations are performed by a separate entity within NASA, such as NASA's CIO office. We noted that the lack of periodic reviews and resulting modifications to the security parameters to ensure compliance with various NASA security plans that guide security at IFMP contributed to the security vulnerabilities.
- NASA Center IT Security Administrators do not report to the IFMP Security Manager; they only report to their immediate superiors for Center-specific issues pertaining to the application security.

It should be noted that NASA has taken steps in fiscal year 2003 to address these concerns. Specifically, NASA has tasked the Office of Security Management and Safeguards (OSMS) to address the Information Assurance function on an organization-wide basis. The role of OSMS will be codified in the revised version of NASA's NPG-2810 document. OSMS will be granted the authority to perform internal security reviews on a periodic basis.

However, the control weaknesses, noted above, can adversely impact the control environment and result in a number of negative consequences, including diminished system stability, degraded system performance, and reduced data integrity. Specific risks include the following:

- By not having clearly documented security configuration standards, NASA runs the risk of bringing a new general support system on-line that is not configured in accordance with agreed-upon standards.
- By not conducting an initial certification and accreditation, NASA management runs the risk of operating a financially significant application that does not meet the security requirements of the NPG 2810.1 regarding security plans, as well as those prescribed by OMB Circular No. A-130.
- By not having completely documented policies and procedures, NASA may not be able to maintain operations due to turnover of NASA and contractor personnel.

We recommend that NASA Management:

- Update NPG 2810.1 to require documentation of security configurations for the installation of software for all major applications and general support systems, as well as guidelines for conducting C&As in accordance with OMB and the NIST guidelines. The Core Financial Security Policy should then be updated to reflect the revised NPG 2810.1.
- Document the technical security configurations for all IFMP major applications and general support systems deployed during the implementation effort.
- Ensure that the C&A process is conducted by an independent party for all IFMP major applications and general support systems:
 - Update the existing IFMP technical administration procedures and application-level security design.

- Perform an independent certification of the financial management system to determine the effectiveness of the controls.
- Finalize its plan that will provide the requisite authority within NASA to perform the information assurance function comprising periodic security controls testing and evaluation and other security-related testing. Further, provide IFMP management with the results of such testing and address the vulnerabilities noted in a timely manner.
- Clarify the roles, responsibilities, oversight functions, and protocol to ensure appropriate IT security monitoring and review for the IFMP Program as a whole.

* * *

With respect to NASA's internal control over RSSI and performance measures reported in the fiscal year 2003 Performance and Accountability Report, Management's Discussion and Analysis – Performance Achievement Highlights, we were unable to apply certain procedures prescribed by OMB Bulletin No. 01-02 within the reporting timelines established by OMB, because of the limitations on the scope of the audit of the financial statements, as discussed in our Report of Independent Auditors, dated January 20, 2004. Further, we did not audit and do not express an opinion on such controls.

We also noted certain other matters involving internal controls that we will report to NASA management in a separate management letter.

This report is intended solely for the information and use of management and Office of Inspector General of NASA, OMB, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

PricewaterhouseCoopers LLP

Washington, D.C.
January 20, 2004

Report of Independent Auditors on Compliance with Laws and Regulations

To Office of Inspector General of the
National Aeronautics and Space Administration:

We were engaged to audit the financial statements of the National Aeronautics and Space Administration (NASA) as of and for the year ended September 30, 2003, and have issued our report thereon dated January 20, 2004, in which we disclaimed an opinion on those financial statements.

The management of NASA is responsible for complying with laws and regulations applicable to the agency. We performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in Office of Management and Budget (OMB) Bulletin No. 01-02, *Requirements for Federal Financial Statements*, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to NASA. Providing an opinion on compliance with certain provisions of laws and regulations was not the objective of our work; accordingly, we do not express such an opinion.

Under FFMIA, we are required to report whether the agency's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger (SGL) at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA section 803(a) requirements. However, as noted in our report dated January 20, 2004, in which we disclaimed an opinion on those financial statements, and based upon the results of the tests we were able to complete, we noted certain instances, described below, which indicated that NASA's financial management systems did not substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and SGL requirements. Because we could not complete our audit, we were unable to determine whether there were other instances of noncompliance with laws and regulations that are required to be reported.

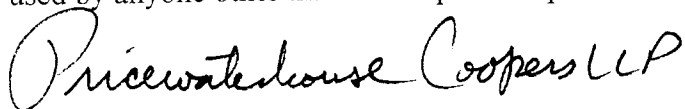
We reported that NASA has material weaknesses related to (1) its audit trail to support that NASA's September 30, 2003, Financial Statements are presented fairly, (2) internal controls surrounding NASA's Fund Balance with Treasury reconciliations, (3) its processes for preparing its financial statements, and (4) internal controls surrounding Property, Plant and Equipment and Materials. In addition, we noted a reportable condition surrounding the design and implementation of NASA's information security program. Further details on these findings, together with our recommendations for corrective action, have been reported separately to NASA in our report on internal control dated January 20, 2004.

Statement of Federal Financial Accounting Standards (SFFAS) No. 1, *Accounting for Selected Assets and Liabilities*, SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, and NASA's Financial Management Manual, require costs to be accrued in the period in which they are incurred and any corresponding liability to be recorded as an account payable, regardless of the associated amounts obligated. However, NASA has designed its new Core Financial Module to include a system edit whereby if costs (and the corresponding liabilities) are greater than the associated obligations, the difference will not be recorded in NASA's general ledger. Instead, these differences are transferred outside of its general ledger and held in a suspense file until additional funds are obligated and the excess costs (and the corresponding liabilities) can be recorded. Similarly, the Core Financial Module will not allow negative costs or downward adjustments to be recorded in the general ledger. We believe that NASA's accounting treatment of costs in excess of obligations and downward adjustments during fiscal year 2003 represents substantial noncompliance with the Federal accounting standards requirements and SGL requirements under FFMIA. We believe that these matters, including the material weaknesses and reportable condition identified in the preceding paragraph, taken together, represent substantial noncompliance with the Federal financial management systems requirements under FFMIA.

In addition, the General Accounting Office's (GAO) report titled, *Business Modernization: NASA's Integrated Financial Management Program Does Not Fully Address Agency's External Reporting Issues*, dated November 2003, also concluded that NASA's Core Financial Module does not substantially comply with FFMIA and identified additional areas of noncompliance. Specifically, GAO reported that NASA's Core Financial Module does not substantially comply with Federal financial management system requirements, as it does not capture and record upward and downward adjustments of obligations incurred in prior fiscal years, and it posts obligations to the general ledger prior to approval. Additionally, the Core Financial Module does not substantially comply with the SGL at the transaction level, since it does not accumulate transaction-based support for adjustments to prior year obligations. The Core Financial Module does not yet provide full-cost accounting capabilities in accordance with SFFAS No. 4, since NASA has not defined, configured, or tested the appropriate cost pools and cost allocation structure, which are critical to implementing full-cost accounting.

We believe that NASA should assign priority to corrective actions for these FFMIA related matters consistent with the requirements of OMB Circular No. A-50, Revised, on audit follow-up.

This report is intended solely for the information and use of the management and Office of Inspector General of NASA, OMB, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.



Washington, D.C.
January 20, 2004